

**SUMMARY ANALYSIS OF AMENDED BILL**

Author: Calderon Analyst: Anne Mazur Bill Number: SB 740  
 Related Bills: See Prior Analysis Telephone: 845-5404 Amended Date: July 25, 2007  
 Attorney: Douglas Powers Sponsor: GE/NBC

**SUBJECT:** Motion Picture Production Direct Tax Revenue Credit/Sale Of Credits To Unrelated Party/Sales & Use Tax Credit In Lieu Of Income Tax Credit

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

X AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as amended July 5, 2007.

X FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED July 5, 2007, STILL APPLIES.

X OTHER – See comments below.

**SUMMARY**

This bill would create a transferable income and franchise tax credit based on wages paid and property used in connection with a qualified production made in California.

**SUMMARY OF AMENDMENTS**

The July 25, 2007, amendments made the following changes:

- Revised the statute of limitations that would apply with respect to the election to claim the credit against sales and use tax (SUT).
- Revised and added definitions.
- Revised requirements relating to selling a credit attributable to an independent film.
- Eliminated the express substantiation requirement.
- Added a requirement for the California Film Commission (Commission) to provide the Franchise Tax Board (FTB) with an annual list of credits allocated to each qualified taxpayer.
- Added a requirement for FTB to accept credit amounts determined by the Commission.
- Made numerous technical changes to references and terminology.

Board Position:

\_\_\_\_\_ S \_\_\_\_\_ NA \_\_\_\_\_ NP  
 \_\_\_\_\_ SA \_\_\_\_\_ O \_\_\_\_\_ NAR  
 \_\_\_\_\_ N \_\_\_\_\_ OUA \_\_\_\_\_ X PENDING

Legislative Director

Date

Brian Putler

8/23/07

These amendments resolved a few but not all of the implementation and technical considerations described in the department's analysis of the bill as amended July 5, 2007. Specifically, the amendments resolved Implementation Consideration (IC) #1, relating to substantiation; part of IC #8, relating to the election by assignees to claim the credit against SUT; IC #11, relating to "new to California"; part of IC #12, relating to the definition of "total production budget"; IC #14, relating to substantiation; IC #16 related to industry terms; IC #17, relating to communication between the Commission and FTB; and IC #18, relating to selling or assigning a credit. The amendments resolved the Technical Consideration (TC) #2, relating to the term "taxable years" in context of the SUT, and TC #6, relating to the use of an erroneous term. The amendments also resolved Policy Concern (PC) #1, relating to assignment of credits.

The This Bill, Implementation Considerations, Technical Considerations, and Policy Concerns sections have been revised and renumbered to reflect the July 25, 2007, amendments and are provided below. The remainder of the department's analysis of the bill as amended July 5, 2007, still applies. The Fiscal Impact and Economic Impact sections of that analysis are provided below for convenience.

## **POSITION**

Pending.

## **ANALYSIS**

### THIS BILL

This bill would create a franchise and income tax credit that would be allocated among qualified taxpayers by the Commission and would not exceed \$100 million in the aggregate annually. The credit amount would be based on direct tax revenues in connection with the production of a motion picture, including television series, in California. The bill would define "direct tax revenues" as the following:

- State income taxes on qualified wages, determined by applying a tax rate of 7½% to such amounts.
- State and local sales and use taxes on qualified property and qualified services, determined by applying the applicable state and local sales and use tax rate to the sales price of such property and services.

The credit amount would be equal to 100% of direct tax revenues if attributable to the production of a qualified motion picture in California, but would equal 125% of direct tax revenues if the qualified motion picture is a television series that relocated to California or an independent film, as those terms are defined in the bill.

The bill would allow the motion picture credit to be claimed against sales or use tax liability in lieu of the franchise or income tax liability. Any such credit remaining would be available for carryover against sales and use tax due for six taxable years. If the credit is in excess of a qualified taxpayer's tax liability, the bill would also allow a qualified taxpayer that is a corporation to elect to assign any portion of the credit to one or more affiliated corporations, as defined. The bill would provide that such election:

- May be based on any method selected by the qualified taxpayer.
- Would be irrevocable for the taxable year the credit is allowed.
- May be changed for any subsequent year if the election is expressly shown on each of the returns of the qualified taxpayer and affiliated corporation that assign and receive the credits.

In the alternative, if the credit is attributable to an independent film, as defined, the qualified taxpayer could sell any portion of the credit to an unrelated party. The qualified taxpayer would be required to report to FTB prior to the sale of the credit "all required information," as specified by FTB. Credits could not be assigned or sold to more than one taxpayer. A qualified taxpayer would be prohibited from assigning or selling any credits that have already been claimed by the qualified taxpayer. Credits in excess of tax liability could be carried over for six years.

The bill would require the Commission annually to provide FTB with a list of qualified taxpayers and the amount of credit allocated to each qualified taxpayer. The bill also would require FTB to accept these credit amounts. As a result, FTB would not have the authority to adjust any credit if the amount could not be reconciled with information received from the Commission.

This bill would require the Business, Transportation and Housing Agency to report to the Legislature by December 31, 2010, on the economic impact of the credit. The bill would authorize this Agency to consult with other organizations and government agencies, including FTB, before completing the report.

The bill also would provide that its provisions are severable if any are invalidated.

The following chart illustrates the criteria for the credit and generally how it would function.

## Qualified Motion Picture Credit

**Credit Amount** – In general, 100% of “direct tax revenues” determined by applying an income tax rate to “qualified wages” and a sales and use tax rate to “qualified property” and “qualified services” during the production period of a “qualified motion picture.” 125% if “TV series relocated to California” or “independent film.” The total amount in the aggregate that can be allocated annually by the Commission is \$100 million.

**Qualified Wages** – Wages and certain fringe benefits paid or incurred by any taxpayer involved in the production with respect to a qualified individual for services performed on a qualified motion picture in this state.

**Qualified Property** – Purchased or leased tangible personal property used in CA in the production of a qualified motion picture and subject to SUT.

**Qualified Services** – Performed within California in the production of a qualified motion picture and subject to SUT.

**Designation & Allocation**  
Taxpayer files verification with Commission to determine and designate qualified taxpayer and allocate credits.

**Filming**  
Taxpayer begins filming within 180 days of designation and must be completed within 30 months of designation.

**Copyright**  
is registered with the US Copyright Office. Such number must be included on the return claiming credit or credit disallowed.

**Taxpayer Claims Credit on franchise tax, income tax, or sales tax return, or assigns the credit to an affiliated corp., or sells to an unrelated party. FTB must accept tax credit amounts determined by the Commission.**

## **Qualified Motion Picture** In general.

A motion picture produced for distribution to the general public and at least 75% of total production days on or after 1/1/08 occur wholly in California.

**Budget requirements.** A **feature film** qualifies if it has a minimum production budget of \$1 million and a maximum production budget of \$75 million. A **movie of the week or miniseries** qualifies if it has a minimum production budget of \$500,000. Also qualifying, a **new TV series** produced in CA, with a minimum production budget of \$1 million licensed for original distribution on basic cable; an **independent film** with a **minimum budget of \$1 million** and maximum budget of \$10 million produced by company that is not publicly traded and is not more than 25% owned by publicly traded companies; and a **TV series that relocated to CA, without regard to episode length** that filmed all prior seasons outside of CA and certifies that the credit is the primary reason for relocating to CA.

“Qualified motion picture” would exclude any of the following:

- Commercial advertising.
- Music videos.
- Motion picture produced:
  - for private noncommercial use, such as weddings or graduations, or
  - by students made as part of any educational course.
- News program, current events or public events program, talk show, game show, sporting event, or awards show.
- Telethon or other production that solicits funds.
- Reality television program.
- Clip-based programming if more than 50% of the content is comprised of licensed footage.
- Documentary.
- Variety program.
- Daytime drama.
- Strip show.
- One-half hour (air time) episodic television show.
- Any production that falls within the recordkeeping requirements of Section 2257 of Title 18 of the U.S. Code.

“Qualified wages” would exclude any of the following:

- Expenses, including wages, related to new use, reuse, clip use, licensing, secondary markets, or residual compensation, or the creation of any ancillary product, including, but not limited to, a soundtrack album, toy, game, trailer, or teaser.
- Expenses, including wages, paid or incurred with respect to acquisition, development, turnaround, or any rights thereto.
- Expenses, including wages, related to financing, overhead, marketing, promotion, or distribution of a qualified motion picture.

## IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation concerns. Additional concerns may be identified as the bill moves through the legislative process. Department staff is available to assist in the resolution of these concerns.

1. The bill would appear to prohibit FTB from reducing an amount of credit allocated by the Commission, but would not provide the Commission with any authority to audit the eligibility of the taxpayer and qualified expenditures following completion of a production. It is recommended that the bill be amended to authorize the Commission to examine actual expenditures and other credit criteria in order to make a final certification of a qualified taxpayer and the amount of credit allowed to each.

2. This bill would allow the Corporation Tax Law (CTL) credit to be assigned to any affiliated corporation. It is unclear what limitations, if any, would be applicable regarding this assignment.
  - a. It is unclear what would happen if a taxpayer assigns a credit and the credit is partially or completely disallowed in a subsequent audit by the department. This would be an especially acute problem if the assignor is either no longer in existence or no longer subject to California's taxing jurisdiction. It is recommended that the statutory scheme expressly state that the department has authority to adjust the tax liability of the assignee (or purchaser) and reclaim the credit amount, with interest, from the assignee.
  - b. Because there may be occasion where the department's audit of the assignor taxpayer's return may occur under a waiver of the statute of limitations, it might become necessary for the department to request waiver of the assignee's (or purchaser's) statute of limitations to prevent the department from being foreclosed from adjusting the assignee's tax liability when the department determines that part or all of the claimed credit should never have been allowed.
  - c. The department would need to be specifically authorized to disclose the necessary confidential tax information of the assignor to the assignee if such an audit situation.
  - d. The assignee would need statutory authorization to obtain tax information from the assignor about the circumstances surrounding the credit that was assigned in order to defend a subsequent proposed adjustment by the department.
  - e. If the credit is disallowed only in part upon FTB audit, it is unclear how this disallowance would be allocated between the assignor and the assignee, particularly if the statute of limitations has expired for one, but not both, of the affected taxpayers. These issues would apply as well for credits that are sold.
  - f. The bill does not specify when the assignee taxpayer can use the assigned credit. It could be used in the same year as the assignor earned the credit or it could be used in the taxable year succeeding the taxable year of assignment and subsequent taxable years, similar to a carryover. In addition, it is unclear what the applicable carry forward period would be for an assigned credit, as well as for credits that are sold.
  - g. An affiliated corporation is not necessarily a member of a unitary group if the tests of unity are not satisfied during the year. The bill does not specify how the assignment would occur in this case.
  - h. The bill would define "affiliated corporation" with reference to R&TC Section 25110(b) as amended by a 1993 statute. The current version of Section 25110(b) contains a different definition. The purpose of referencing a former version of the statute is unclear and may result in disputes. It is suggested that the bill more clearly define this term.
  - i. The bill does not specify what would happen if a member subsequently entered or left the group.
  - j. The bill would allow a qualified taxpayer to assign a credit based on "any method selected by the qualified taxpayer." It is not clear what "any method" refers to—e.g., the amount of credit that is transferred or how an election is made or something else. It is suggested the bill be amended to clarify this provision.

- k. The bill would make an assignment election irrevocable for the tax year the credit is allowed, but would permit the election to be changed for any subsequent year. It is suggested the bill clarify in what way the election could be “changed.” If the change would allow remaining—i.e., carryover—credit to be assigned to another taxpayer, it would appear to conflict with the rule that a credit could be assigned or sold to only one taxpayer.
3. The mechanics of the election to assign or sell the credit should be developed to require a formal election on a timely filed original return and a system to notify FTB in the form and manner prescribed by FTB in forms and instructions.
4. The bill states that where the credit exceeds the qualified taxpayer's tax liability, the taxpayer could elect to assign any portion of the credit allowed. This suggests that any or all of the allowed credit could be assigned, not just the amount in excess of the qualified taxpayer's tax liability. This bill should clarify the amount available for assignment.
5. The tax consequences for the assignment or sale of the credit, such as recognition of income to seller or purchaser or a required basis computation, are unclear.
6. If FTB would be required to verify copyright registration number and “qualified taxpayer” designation when processing returns claiming the credit could result in a new manual workload, unless this information is otherwise available electronically.
7. a. The bill would allow the credit earned under the income or franchise tax laws to be used, by either the taxpayer earning the credit or an assignee of that taxpayer, to offset liability under the Sales and Use Tax Law. This provision would substantially complicate administration and potentially confuse taxpayers. For example, the bill language states that BOE would have four years from the last day of the month following the reporting period in which the Commission approved the credit to recover an “erroneous” credit or refund; however, FTB normally has a four-year time period from the date of a timely filed return for making deficiency assessments under the Personal Income and Corporation Tax laws (PITL and CTL). Because the Commission would approve the credit generally before filming begins, the four-year provided by the bill could expire well before the credit is claimed on a return.  
  
b. The mechanics of the election should be refined to require a formal election on a timely filed original return in the form and manner prescribed by FTB in forms and instructions.
8. This bill would allow a qualified taxpayer to make an irrevocable election to claim this credit against sales and use tax liability. The language would be subject to the argument that it allows claims for credit of SUT based on an amount of credit that is in excess of the franchise tax liability. It is suggested the bill be amended to clarify that a taxpayer may not claim credits against both SUT or franchise and income tax, or make an otherwise nonrefundable credit, refundable. It is also suggested the bill be amended to provide that the refund allowed under the SUT in-lieu election may not exceed the taxpayer's "net tax" or "tax."

9. In defining a “qualified motion picture,” the bill states that, in computing total wages paid or incurred for the production of a qualified motion picture, all amounts paid or incurred by all persons or entities that share in the costs of the qualified motion picture shall be *aggregated*. Aggregation language appears to contemplate various persons paying wages in connection with the production of a motion picture. This seems to conflict with the fundamental definition of a “qualified taxpayer” as being that taxpayer who has paid or incurred the expenses for the qualified amount.
10. The definition of “qualified motion picture” would require on or after January 1, 2008, at least 75% of the “total production days” to occur wholly within California or 75% of the use of the total production budget occurs within California. With respect to “total production days,” department staff assumes this means a California production day is a day of production occurring entirely in California and that at least 75% of all production days must be California production days. If staff’s understanding of the author’s intent on this point is correct, then the bill should be clarified accordingly.
11. The bill states that property is qualified if it is used within California in the production of a qualified motion picture. The bill does not provide a standard or minimum amount of “use” that is required. It is recommended the term “use” be clearly defined to avoid disputes regarding how much use would be required. The definition could be based, for example, on the percentage of time the property is used in the production of a qualified motion picture.
12. The bill would require the qualified taxpayer to provide certain information—such as the amount of qualified wages paid and type of qualified property purchased, but not qualified services—to the Commission or the credit would be disallowed. However, the bill does not provide the Commission with authority to audit the eligibility of the qualified taxpayer or verify qualified expenditures. It is suggested that the bill be amended to provide the Commission with the authority and responsibility to certify the credit following completion of the production and an audit to ensure that planned expenditures were incurred and qualified and that all other criteria for the credit were met.
13. The bill would define “qualified services” as services performed within California in the production of a qualified motion picture. For purposes of computing “direct tax revenue,” the bill would apply a sales or use tax rate to qualified services. Because the bill also specifies that payments to independent contractors would be treated as wages, it is unclear how payments for qualified services are to be distinguished from payments treated as qualified wages. Moreover, payments for services are generally exempt from sales and use taxes.
14. Various film industry terms are used throughout this bill without definition, such as “new television series.” It is recommended that these terms be clearly defined to simplify administration and avoid disputes.



## TECHNICAL CONSIDERATIONS

1. The language of the bill regarding assignment of the credit to one or more members of an affiliated group makes an erroneous reference. The provision attempts to override credit rules for passthrough business entities, which are in Revenue and Taxation Code (R&TC) section 23036(j), but instead references 23036(i), relating to credit limitations for disregarded entities. To correct this reference, on page 18, line 28, “subdivision (i)” should be replaced with “subdivision (j)” in lieu thereof.
2. It appears the intention of this bill is to allow the credit only at the shareholder level and not to allow an S corporation to reduce entity level tax by any portion of such credit. The bill, however, would deny the credit to an S corporation only for taxes imposed under Chapter 4.5 (commencing with R&TC section 23800). Pursuant to section 23802, an S corporation is subject to the tax imposed under Chapter 2 (section 23101) and Chapter 3 (23501), but at a reduced rate (i.e., the 1 ½% entity-level tax). Chapter 4.5 only imposes the built-in gains tax and the tax on passive income. If the intent is to prohibit an S corporation from using the credit against any of those taxes, including the 1 ½ % tax, the reference should be corrected accordingly.
3. A portion of the amount of the credit would be an amount equal to an approximation of the sales and use tax on qualified property and qualified services used in a qualified production; however, there is no requirement that the qualified taxpayer actually pay sales and use tax on the purchase or lease of the property or services. It is recommended the bill be amended to add such a requirement.
4. This bill would require a taxpayer to file a written “verification” with the Commission apparently to apply for the credit. Because the bill would not provide authority for the Commission to conduct an examination or verification, in order to avoid taxpayer confusion, it is suggested that the word “verification” be replaced with “application” as that term is used elsewhere in the bill.
5. On page 8, lines 24 and 25, and 17, lines 6 and 7, after “qualified” strikeout “taxable”.
6. On page 10, lines 19, 21, 23, and 25, strikeout “assigned or”.
7. On page 10, line 22 and page 19, line 32, strikeout “paragraph” and insert “subdivision” in lieu thereof.
8. On page 11, line 12 and page 20, line 23, strikeout “if” and insert “of” in lieu thereof.
9. On page 15, lines 30 through 32 appear to be missing words.
10. On page 21, line 19, strikeout “Section 23685” and insert “Section 17053.85” in lieu thereof.

## **FISCAL IMPACT**

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved, but are anticipated to be significant relating to manual processing—if the department is required to verify copyright registration numbers or otherwise validate the credit during the initial processing of tax returns claiming the credit—and audit activity to verify eligibility of the taxpayer claiming the credit and correctness of credit amount claimed, particularly with respect to transferred credits. The costs to conduct such lengthy and complex audits would be substantial.

It is recommended that the bill be amended to include appropriation language that would provide funding to implement this bill. Lack of an appropriation will require the department to secure the funding through the normal budgetary process, which will delay implementation of this bill.

## **ECONOMIC IMPACT**

### Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses:

Estimated Revenue Impact of SB 740 Effective for Tax Years BOA 1/1/2008 Assumed Enactment Date After 6/30/2007 (\$ in Millions)		
2007/08	2008/09	2009/10
- \$5	- \$80	- \$110

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

### Revenue Discussion

The revenue impact of the motion picture production credit is dependent on the amount of qualified wages and qualified tangible personal property purchased or leased, and the portion of the allocated credit that is used to reduce tax liabilities.

Based on employment data for the film/video production industry in California and adjusting for tangible personal property, total credits for qualified wages and property are anticipated to exceed the annual aggregate credit cap of \$100 million.

The \$100 million of allocated credits are adjusted for the following reasons:

- 1) Projects that are approved for credit allocation in 2008, but for which the project is not completed by the end of 2008, and
- 2) Projects that are approved by the Commission but are later abandoned and therefore ineligible for credit allotments initially assigned.

Credits generated for the 2008 taxable year are projected to be \$72 million derived as follows:

$\$100 \text{ million in credits} \times 75\% \text{ (percentage of films that are allocated a credit for 2008 and are completed before the end of 2008)} \times 96\% \text{ (1 - 4\%, percentage of films for which a credit is allocated in 2008, but is subsequently abandoned prior to completion)} = \$72 \text{ million.}$

Unused credits may be assigned to members of a corporate qualified taxpayer's commonly controlled group and or sold by independent film producers (as defined) to other taxpayers. Therefore, it is assumed that of the \$72 million in credits generated during 2008, on average, taxpayers will use 77% or \$55 million of these credits. It is assumed that carryover credits will be used, on average, over two years.

Total credits generated are adjusted to reflect a usage pattern on a fiscal year basis. To allow time for the Commission to establish a new approval process, a portion of the revenue impact for fiscal year 2007/2008 (which reflects only six months) is shifted to fiscal year 2008/2009.

## **POLICY CONCERNS**

1. This bill would allow a taxpayer to sell or assign unused tax credits to a third party, presumably which would be purchased at a discount and paid at the face amount by the state. Tax credits influence taxpayer behavior by providing tax relief in exchange for incurring a specified expense or modifying behavior to achieve a state-endorsed purpose. Authorizing the selling of credits permits the third party purchaser to offset income unrelated to the state-endorsed purpose and provides a benefit to a taxpayer that did not actually incur the underlying expense or risk associated with the expenditure.
2. It may be more cost efficient and simpler for the department to administer a refundable income tax credit rather than a credit that can be assigned or sold to another taxpayer or applied against sales or use tax. However, refundable credits historically have been susceptible to fraud.
3. This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

4. Conflicting tax policies come into play when a credit is provided for an expense item for which preferential treatment is already allowed in the form of an expense deduction. Providing both a credit and allowing the full amount to be deducted would have the effect of providing a double benefit for that item. On the other hand, making an adjustment to reduce basis in order to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy. In the case of a one-time business expense deduction, the reduction of that expense by the amount of the credit would not create an ongoing depreciation difference.
5. Conflicting tax policies result when an expenditure qualifies for more than one credit, resulting in a double tax benefit. For example, expenditures eligible for this credit might also qualify for the Hollywood<sup>1</sup> enterprise zone credit. It is suggested that the bill be amended to prevent a taxpayer from claiming any other credit with respect to any qualified expenditure on which a motion picture production credit or a commercial production credit is claimed.
6. This bill would apply for taxable years beginning on or after January 1, 2008; however, there is no language in the bill that would prevent the credit from being based on amounts incurred—wages paid or property purchased or leased—prior to that date or prior to the date the taxpayer is designated as qualified by the Commission.

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<sup>1</sup> In Los Angeles, the East Valley, Hollywood, and Central L.A. have received conditional designation from the Department of Housing and Community Development to offer tax incentives during a zone redesignation period. Numerous other areas in California also have conditional designation as enterprise zones.